Massachusetts Electric
A National Grid Company

January 24, 2005

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, MA 02110

Re: D.T.E. 04-115

Dear Secretary Cottrell:

On behalf of Massachusetts Electric Company and Nantucket Electric Company, we are submitting reply comments in the above-captioned docket. Thank you very much for the opportunity to submit these comments.

Very truly yours,

Thomas G. Robinson
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cc: Joseph Rogers, Office of the Attorney General

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COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Request for Comments on the Procurement of Default Service Power Supply For Residential And Small Commercial and Industrial Customers	)	DTE 04 - 115

REPLY COMMENTS OF MASSACHUSETTS ELECTRIC COMPANY AND NANTUCKET ELECTRIC COMPANY

Massachusetts Electric Company and Nantucket Electric Company (collectively "Mass. Electric" or "Company") submit the following reply comments in relation to Default Service power supply for residential and commercial[1] customers ("Small Customers").

Mass. Electric makes the following observations in relation to some of the key issues contained in the initial filings.

I. Power Contract Duration and Frequency of Solicitation

The Initial Comments filed in this proceeding reveal broad support for continuation of the approach adopted by the Department in D.T.E. 02-40 to require that Default Service power supplies for Small Customers be procured through semi-annual solicitations for one-year contracts to supply one-half of the power requirements of Default Service loads. MECo Initial Comments, pp. 7-11; NSTAR Initial Comments, pp. 2-3, 14-16; WMECo Initial Comments, pp. 1, 3-7; DOER Initial Comments, p. 3. *Cf.* Attorney General Initial Comments, p. 3 ("Until the wholesale market rules have been in place and have a proven track record of predictable results, the Department should proceed cautiously as it considers changes to the current pricing and procurement design of default service."). These comments reflect a conclusion that the

[1] Commercial customers in these reply comments represents Mass. Electric's customers receiving service pursuant to its Rate G-1, General Service and streetlighting tariffs. This is consistent with the Department's definition of commercial customers for Mass. Electric pursuant to DTE 99-60.

Department's existing approach to Default Service power supply procurement strikes an appropriate balance between the competing goals of providing Small Customers protection from unreasonable price volatility and providing a market based price that is compatible with the development of an efficient market for retail competition. MECo Initial Comments, pp. 7-11; NSTAR Initial Comments, p. 2; WMECo Initial Comments, pp. 3-7; DOER Initial Comments, p. 8; Select Energy Initial Comments, p. 3; Strategic Initial Comments, pp. 4-5; Constellation Comments, p. 3. The Department's existing approach advances the clear legislative policy in favor of the development of a competitive retail market as well as conforming to the more specific statutory requirements in G.L. c. 164, § 1B concerning the pricing and procurement of Default Service. MECo Initial Comments, pp. 7-11; NSTAR Initial Comments, p. 2; WMECo Initial Comments, pp. 3-5; DOER Initial Comments, p. 8.

The majority of respondents, including Mass. Electric, have argued against the use of power supply contracts longer than one year on the grounds that longer term contracts have more inherent risk than short term contracts and that, as a result, power purchased under contracts with a duration greater than one year will be higher priced than that purchased under short term arrangements. MECo Initial Comments, pp. 7-11; NSTAR Initial Comments, pp. 17-18; DOER Initial Comments, pp. 10-12; Calpine Initial Comments, pp. 4-5. Extending the duration of power supply contracts necessarily increases the supplier's exposure to risks related to fuel prices, customer migration and regulatory changes and this increased supplier exposure to risks will necessitate higher bid prices to assume those risks. Id. Moreover, many commenters agreed that increasing the duration of power supply contracts increases the likelihood that the Default Service prices paid by consumers will be inconsistent with current conditions and, thus, with the development of an efficient, competitive market. MECo Initial Comments, pp. 7-11; NSTAR Initial Comments, pp. 18-19; WMECo Initial Comments, pp. 9-11; DOER Initial Comments, pp. 10-12; Select Energy Initial Comment, p. 4; Strategic Initial Comments, p. 6.

The limited number of commenters advocating that the Department reconsider the structure of Default Service supply procurement adopted in D.T.E. 02-40 in favor of a requirement or an option of longer term supply contracts fail to acknowledge that their recommendations would likely lead to higher costs for consumers, much less to explain why increasing the likelihood of higher prices for consumers is necessary to either protect consumers or support the development of a competitive market. The Office of the Attorney General, Fitchburg Gas & Electric Company, UCS *et a.l*, and the Utility Workers Union of America all argue for a laddered portfolio approach, incorporating supply contracts for varying length, with the Attorney General and Fitchburg supporting contract terms up to three years in length, Attorney General Initial Comments, pp. 6, 10; Fitchburg Initial Comments, pp. 2-3; UCS *et al* supporting contract terms up to ten years for renewable energy[2]; UCS et al. Initial Comment, p. 5; and the Utility Workers supporting "truly long term" contracts, including those related to station output, not load requirements "[a]s long as the decision to purchase for a longer term appears to be prudent based on all of the available facts." Utility Worker Initial Comments, p. 6.

As explained above, however, there is a broad consensus that longer term contracts will increase costs to Default Service customers and not one of those parties advocating the use of longer term contracts addresses, much less attempts to challenge this consensus. While the Attorney General did acknowledge "the complexity of the issues involved" and urged "the Department [to] … proceed cautiously as it considers changes to the current pricing and procurement design of default service," Attorney General Initial Comments, pp. 2, 3, the comments supporting the use of longer term contracts are most remarkable for the absence of any substantive support for the positions taken. The analyses contained in Mass. Electric's

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[2] While the Initial Comments of UCS *et al*. do address the question of the appropriate structure of Default Service procurements separate and apart from issues relating to whether particular provision(s) should be made for the procurement of "renewable energy generation," the principle focus of those comments relates to issues concerning the procurement of "renewable power" and compliance with the Renewable Portfolio Standard that are outside the scope of the current notice of inquiry.

Initial Comments highlight not only that longer term contacts lead to increased costs and to less reflection of current market prices, but also that laddering did not significantly improve price stability over and above the current procurement approach, nor necessarily lead to lower prices.

Finally, while Mass. Electric continues to believe that the Department's current approach to Default Service procurement strikes the correct balance between price stability and the reflection of current market conditions, to the extent that the Department nevertheless wishes to increase the stability of prices for Small Customers (through reducing the magnitude of price changes rather than the frequency of price changes), Mass. Electric submits that it should consider quarterly solicitations of one-year contracts. Initial Comment of Mass. Electric, pp. 2. Compare Initial Comments of Calpine, p. 3. In contrast, while agreeing that the Department's current approach strikes the correct balance between price stability and the reflection of current market conditions, in its Initial Comments NSTAR suggested that the Department consider semi-annual solicitations of two-year contracts. Mass. Electric submits that the tables and charts in Attachment 1 demonstrate that the price and stability benefits of moving to two-year contracts are small compared to the current approach[3] and significantly less than that achieved by four procurements of 25% of the load under one-year contracts[4]. In these circumstances, Mass. Electric urges the Department to avoid increasing costs to Smaller Customers in order to achieve such a small improvement in price stability. Given the increased risk exposure, with little counter-balancing benefit, Mass. Electric opposes extending the contract duration.

II. State-wide Approach and Auctions

Given the diversity of opinion regarding the potential benefits and issues surrounding the use of a state-wide approach and value of auctions under such a regime, Mass. Electric

[3] Only a 2% improvement in the absolute average percentage price change.
[4] An 8% improvement in the absolute average percentage price change.

recommends the Department investigate this approach further as a result of this docket. However, the Company offers the following observations on some of the issues identified in others initial responses.

Pricing:

A number of respondents cite the need to accommodate differential prices for each utility's service territory. A statewide approach could in fact have a single price for commodity in each Load Zone but common across all service territories within that load zone. A single price for utility-provided commodity service in each load zone would be simpler for customers to understand and would facilitate the development of marketing strategies for competitive suppliers.

Fitchburg Gas and Electric Company raise the issue of differences in load profiles as a reason to not adopt a statewide approach. The degree of variation between the load profiles of smaller customers within the state of Massachusetts is not material (see chart in Attachment 2 which compares FGE, WMECo, NStar and Mass. Electric residential load shapes). The price of electricity is driven by the shape of the load rather than the volume, and therefore any differences in consumption levels between the utilities' service territories will not disadvantage one set of customers compared to another under a load zone-based central procurement.

Some respondents refer to the benefits of near real-time pricing for smaller customers, or alternatively, longer term prices against which competitive suppliers can offer a fixed saving to customers. It is inappropriate to place Small Customers on a rate which is tied directly to the New England ISO spot price. The Department's earlier observations that "the competitive options available for residential and small C&I customers are limited … [and that] eliminating the fixed, six-month [Default Service pricing] option would be inconsistent with these customers' wishes for price stability" remains true today. See Default Service Pricing and Procurement, D.T.E. 02-40-C, p. 44 (2003).

Legislation:

Contrary to WMECo's view, Mass. Electric believes that auctions do not necessarily require legislation. Under M.G.L. 164 1B (d) "the department may authorize an alternate generation company or supplier to provide default service, as described herein, if such alternate service is in the public interest." A properly designed auction program would be no more than an outsourcing of the provision of Default Service procurement process as contemplated under the law.

Contracting Counterparty:

This has been correctly identified as a material issue, but not one that is without resolution. The MPUC, in issuing its Advisory Opinion,[5] placed reliance upon the Maine statutes[6], the Commissions rules,[7] and the contract for Transmission and Delivery services between the supplier and the utility to conclude that, despite the absence of a contract for the provision of commodity between the utility (or the customers) and the supplier, "a contract between either the purchaser of electricity or the [Maine Public Utilities] Commission is not necessary or appropriate". The Maine statute mandates the MPUC to establish and administer a bid process to select standard offer service providers, and permits the MPUC to apply discretion in determining the duration of standard offer supplies. Massachusetts does not have the equivalent law upon which to rely and

[5] Maine PUC Docket No: 2000-808 Nov 28, 2000 – Advisory Opinion Regarding Rights and Obligation of Standard Offer providers.

[6] Title 35-A, Chapter 32, Section 3212

[7] Chapter 301 Section 3(B)

therefore to is not practical for the Department to adopt the current Maine approach. However, Mass. Electric considers that there are alternative approaches which would permit a statewide auction to operate effectively without the need for legislation and without the residual risks which exist with the Maine process. The Company would welcome the opportunity to explore such alternatives and requests that the Department investigate statewide auctions further.

The New Jersey Approach:

The New Jersey wholesale auction advocated by Morgan Stanley and Duke Energy includes longer term contracts, the disadvantages of which Mass. Electric has already highlighted. In addition, due to the wholesale nature of the auction, there is little opportunity for the development of retail competition under such an approach[8]. Mass. Electric continues to believe that a vibrant retail market is essential if we are to avoid a continuance of market fixes such as Locational Installed Capacity ("LICAP") and Reliability Must Run ("RMR") contracts, and the risk of a return to central resource planning with the attendant prospect of customers bearing further stranded costs.

III. Default Service Name Change

A number of alternative names for Default Service have been proposed. Mass. Electric is primarily concerned with having the Department's imminent approval to enable Standard Offer customers to transfer to a newly-named Default Service. Although Mass. Electric is not entirely opposed to the term 'Last Resort' service, it does not carry a great deal of meaning when, for the vast majority of Small Customers, it is currently their only possible power source. Given the

[8] As at December 2004 the New Jersey Board of Public Utilities reports that 8,644 (less than 2%) of non-residential customers have switched to competitive suppliers. Some 26,275 (8%) of non-residential customers in Massachusetts have switched to competitive suppliers as at November 2004 (source: DOER migration data).

wider range of support for Basic Service, Mass. Electric requests that the Department approve the utilities' use of this name beginning in March 2005.

IV. Other Issues

Credit Worthiness Requirements

Mirant and Calpine raise the differences in approach between utility credit requirements. Mass. Electric's current policy requires all winning suppliers to provide credit support. Suppliers, or their guarantors, that possess an investment grade credit rating are permitted varying degrees of unsecured credit by Mass. Electric. The higher the supplier's or guarantor's credit rating, the greater the level of unsecured credit that is extended. Should a supplier's or guarantor's credit exposure for the current award, including any exposures from prior awards, exceed the unsecured level established by Mass. Electric, the supplier or guarantor is required to post additional credit support in the form of a letter of credit or cash deposit. Suppliers that do not posses investment grade ratings are required to provide a guarantee from an investment grade entity or post additional credit support in the form of a letter of credit or cash deposit.

NStar in its recent RFP of January 1, 2005 required suppliers to provide letters of credit for $40 million dollars (pro-rated to the portion of load bid by the counterparty) regardless of the credit rating of the counterparty. Although the cost of a letter of credit depends upon the financial status of the counterparty, Mass. Electric estimates that letters of credit may cost between 1-2% of the value of the letter of credit. Assuming a rate of 1.5%, the cost in this case would total $600,000. The load covered by the NStar RFP was approximately 6,000 GWh. This would add some 0.01¢/kWh[9] to rates, assuming bidders include the cost of letter of credit in their

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[9] This impact would be less than, but of the same magnitude, as the letter of credit requirement adopted for "standard offer service providers" by the Maine PUC in 2001. Section 3.A.2.a of Chapter 301 of the Maine PUC's rules requires a bond, letter of credit or corporate guarantee in an amount equal to 1¢ per kWh to be supplied during the term of a standard offer supply contract. Assuming 1.5% cost for a letter of credit, this would equate to 0.015¢/kWh.

bids. Mass. Electric takes comfort from the credit rating of investment grade counterparties and avoids this premium, thus allowing Mass. Electric customers to "self-insure" for such counterparties, given the relatively low risk of default in these circumstances. Non-investment grade counterparties are still able to compete if they accommodate Mass. Electric's credit requirements and bid the lowest price. Should the Department seek to develop a common statewide approach, it should carefully balance the risks born by customers with the costs of insuring against supplier default. The Department should also note that any increase in premiums associated with longer term contracts would be exacerbated by the application of credit requirements to these higher costs.

Retail costs in Default Service Rates

Despite the Department's clear focus on procurement aspects of the provision of Default Service to customers, Direct Energy, Dominion and Strategic Energy advocate the transfer of certain so called 'retail service' costs from distribution rates to Default Service rates. First, the Department is currently reviewing the transfer of recovery of costs associated with utilities providing Default Service customers, such costs which are currently being recovered through distribution rates, from distribution rates to Default Service rates in a generic investigation in Docket No. D.T.E. 03-88. In this investigation, the Department has already enumerated the type of costs it would consider for such a transfer, and has removed from review those costs that the utilities would continue to incur if they no longer had to provide Default Service to their customers. Therefore, Mass. Electric believes the Department has already addressed the concerns of Direct Energy, Dominion and Strategic Energy in D.T.E. 03-88. In addition, Mass. Electric considers that some of the costs identified by these suppliers are not incurred by utilities today (e.g. customer acquisition & attrition costs and licensing costs) and therefore cannot be 'removed' from distribution rates.

The further suggestion by Direct Energy (and similarly echoed by Strategic Energy) to create separate utility retail affiliates has been considered as part of the December 29, 2000 Report to the General Court Pursuant to Section 312 of the Electric Restructuring Act, Chapter 164 of the Acts of 1997 on Metering, Billing, and Information Services ("MBIS"). Under that section of the law, the legislature asked the Department and the DOER to investigate and study "whether MBIS should be unbundled from other services provided by distribution companies and, instead, be competitively provided." The Department's response was clear and unambiguous in relation to billing and customer service:

- "Should billing-related services be unbundled from other monopoly service provided by distribution companies and provided through a competitive market? No."
- "Would the introduction of competition of billing-related services result in substantive savings to consumers? No."

This conclusion remains sound and is unaffected by the proposed model where metering would be retained within the utility. There are significant issues associated with the creation of utility supply affiliates as envisioned by Direct Energy.

1. Cost
    a. The separation of customer service from the distribution business will incur one time separation costs.
    b. Additional ongoing operating costs will be incurred as a result of the reduced economies of scale and duplication of activities in order that the distribution business and the retail affiliate can operate as independent and separate companies.
    c. Re-branding of one or other of the companies would also incur significant costs.
2. Risk

a. Under the structure and practices that have developed in Massachusetts, it is essential that utilities maintain their billing and customer service operations to provide the data to settle accounts for power supply at the ISO, maintain customer protections, assure accurate bills, reduce the cost of entry by new suppliers, and assure our ability to maintain reliable service in the event of supplier failures. A change to the market structure to permit consolidated supplier billing and to introduce competition into the billing and customer service functions was not contemplated when restructuring was implemented. To make such a fundamental change in the market structure at this stage in the development of the market would require significant time and incur expense to ensure that the appropriate infrastructure required to support the more complex data flows and to assure a seamless recovery from a supplier failure were in place and that the current customer protections were maintained.

3. <u>The creation of barriers to the development of the competitive retail market</u>

a. Many existing competitive suppliers in Massachusetts have stated that they do not wish to perform billing and customer service activities and are happy with the utilities providing these services at no extra charge. By having competitive billing and customer service, barriers to market entry may actually be raised and Massachusetts may only end up with one or two market players resulting in little effective competitive choice for Small Customers in the Commonwealth.

V. <u>Conclusion</u>

In summary, there is a substantial degree of consensus surrounding the risks and costs of long term contracts; the extent to which more frequent procurements may be beneficial; and for renaming Default Service as Basic Service. Mass. Electric believes that a well designed statewide auction may have benefits and recommends establishing a collaborative process for considering the potential for such an approach, and looks forward to actively participating in further dialogue on these matters. Mass. Electric also believes that there are other changes which could facilitate the development of a vibrant retail market but which are outside the scope of this docket.

Respectfully submitted,

MASSACHUSETTS ELECTRIC COMPANY
NANTUCKET ELECTRIC COMPANY
By their attorneys,

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Dated: January 24, 2005

Attachment 1[10]

Table 1

Price over two year period $/MMBtu	Semi-annual procurements of one year contracts (Fixed price)	Semi-annual procurements of two year contracts (Fixed Prices)
Avg	5.2	5.1
Max	5.9	5.7
Min	4.2	4.2
Spread	1.7	1.5
% Spread	33%	30%

There is not a significant improvement in price stability when comparing the NStar proposed approach of semi-annual procurements of two year contracts with the existing semi-annual procurement of annual contracts.

Table 2

Absolute[11] **% change in 'retail' prices**	Semi-annual procurements of one year contracts (Fixed price)	Semi-annual procurements of two year contracts (Fixed Prices)	Price Based On 4, 25% Procurements (Fixed Prices)
Avg	15%	13%	7%
Max	25%	19%	12%
Min	7%	7%	2%

The average absolute price change over the two-year period is approximately 2% less under semi-annual procurements of two year contracts compared to the current procurement policy of semi-annual procurements on one year contracts. By moving to quarterly procurements of one-year contracts a more significant improvement of approximately 8% is seen compared to the current procurement approach.

Table 3

Average absolute % deviation from Actual Gas Prices over 2 Year Period[12]	Semi-annual procurements of one year contracts (Fixed price)	Semi-annual procurements of two year contracts (Fixed Prices)
Avg	14%	14%
Max	55%	55%
Min	1%	1%

The extent of connection to underlying market prices is comparable between the two approaches.

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[10] See Mass. Electric Initial Comments submitted in response to DTE 04-115 for details of the data and methodology used in this analysis.
[11] Absolute % Price change = Absolute (i.e. all negative values are changed to positive values) % change in price
[12] Average Absolute % Deviation = Σ_i^n (Absolute (i.e. all negative values are changed to positive values) difference between the contract and monthly market prices / monthly market price * 100)/n, where n= number of months

Chart 1 – Prices obtained under various procurement approaches.

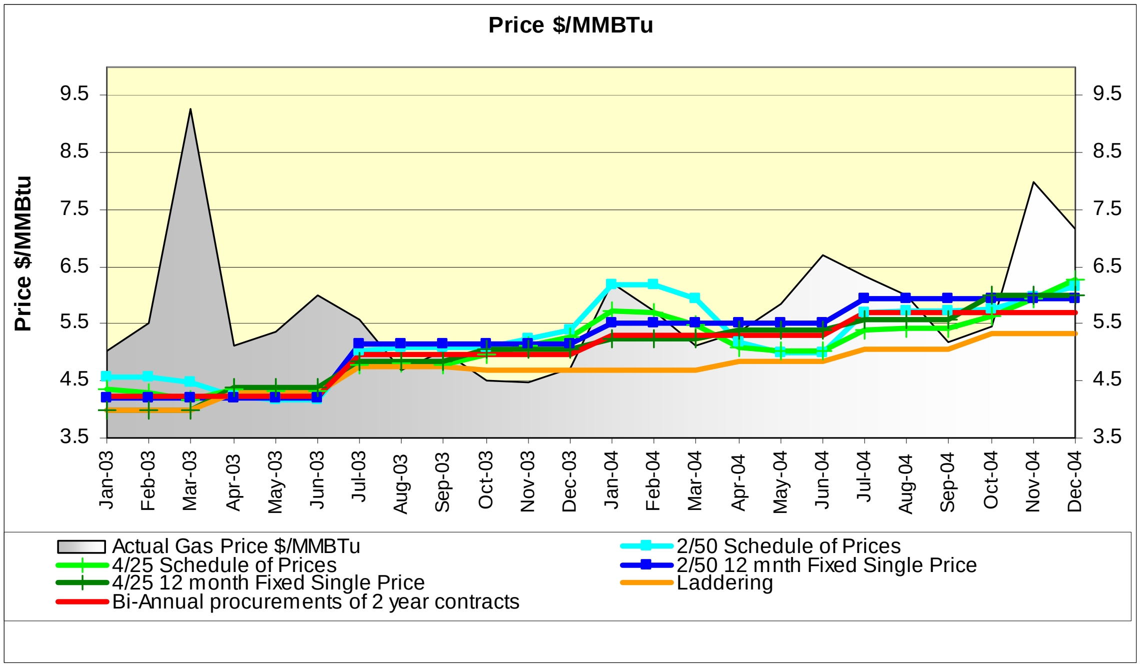


Chart 2 – Prices obtained under a generic falling market

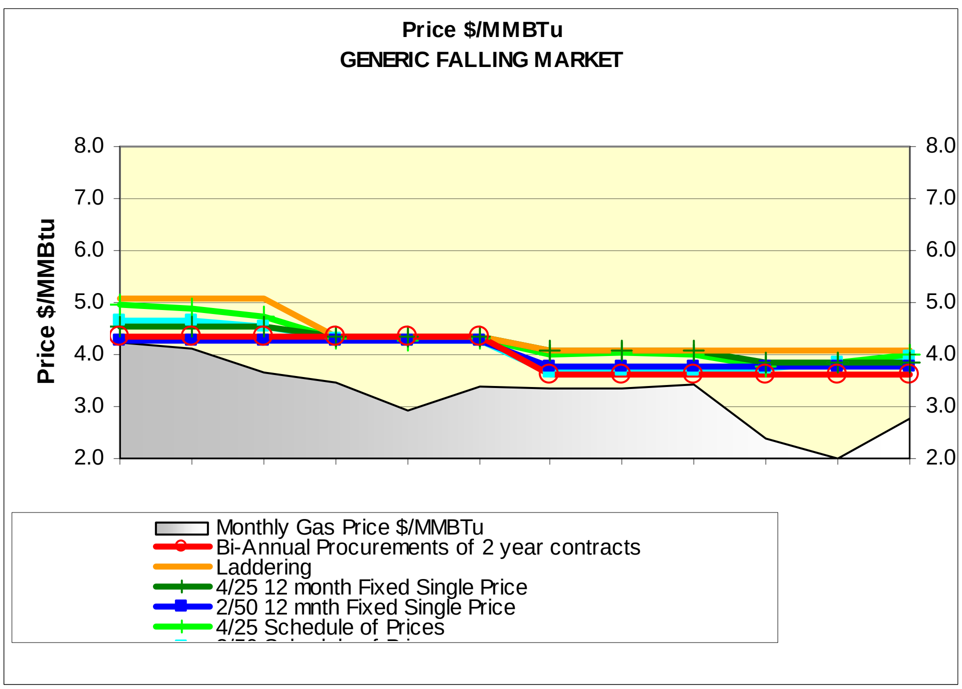
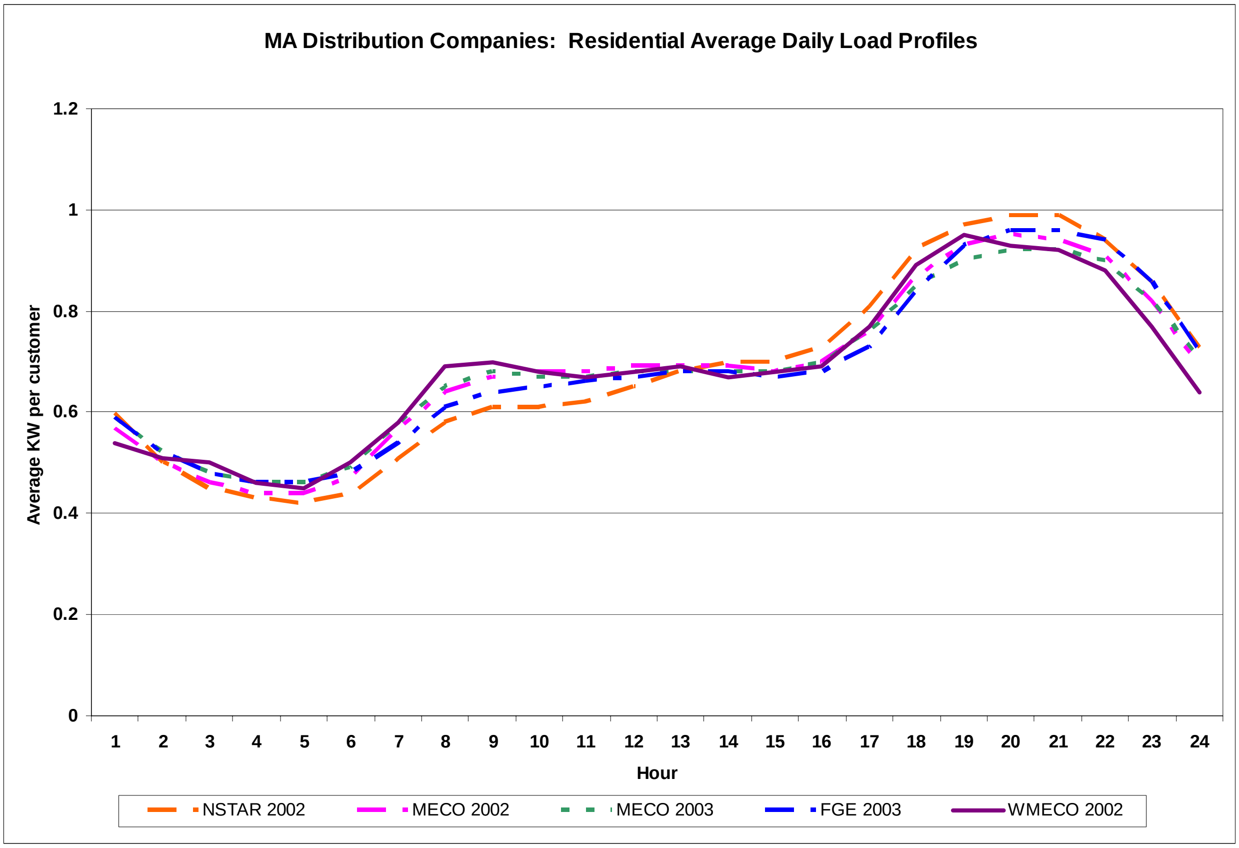


Chart 3



The graph shows the average residential customer load shapes from the MA distribution companies. These shapes were developed by downloading information from each company's web site, then "normalizing" to reflect 6,000 kWh/year; as the price of the load is driven by the load shape rather than the level of consumption. Mass. Electric believes that a state-wide auction should combine the load profiles for each utility customer class within each load-zone. As the average daily load shapes are consistent, consumption patterns should not create a material difference in the price for an aggregate load shape when compared with a price for each load shape.